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May 1, 1998

Cynthia L. Johnson
Director, Cash Management Policy and Planning Division
Financial Management Service
U.S. Department of the Treasury
401 14th Street, SW -- Room 420
Washington, DC 20227

**Re: Notice of Proposed Rulemaking:
31 CFR Part 210 -- Federal Government
Participation in the Automated Clearing House**

Dear Cindy:

On behalf of the National Automated Clearing House Association (NACHA), I respectfully submit these comments in response to the notice of proposed rulemaking (NPRM) issued by the Treasury Department's Financial Management Service (FMS) regarding the Federal Government's participation in the Automated Clearing House (ACH) Network.[1] The ACH Network is a nationwide electronic funds transfer (EFT) system that provides for the interbank clearing of credit and debit transactions and for the exchange of information among participating financial institutions. EFT includes ACH, Fedwire, and transfers made at automated teller machines (ATMs) and point-of-sale (POS) terminals. Part 210, which relies upon and implements Treasury's statutory responsibility to collect and disburse public funds, regulates the rights and duties of parties to transactions originated or received by Federal agencies through the ACH Network, just as other Treasury rules regulate the rights of parties to Treasury checks. The Federal Government is the largest single user of the ACH Network, originating and receiving millions of transactions each month.

BACKGROUND

Two recently enacted laws are increasing substantially the use of the ACH Network by Federal agencies. Provisions in the *North American Free Trade Agreement*

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[1] NACHA represents more than 13,000 financial institutions through its 35 regional ACH associations, six councils and corporate Affiliate Membership program. A leader in the payments industry, NACHA develops operating rules for the Automated Clearing House Network and for emerging electronic payment solutions in the areas of Internet commerce, bill payment and presentment, financial electronic data interchange, cross-border transactions, electronic checks, and electronic benefits transfer. NACHA produces marketing collateral and technical publications, and provides extensive education services, including major conferences and seminars. Visit NACHA on the Internet at ***www.nacha.org***.

ACH # 0006

Implementation Act (NAFTA) and in the *Debt Collection Improvement Act of 1996* (DCIA) mandate the use of EFT for the collection of certain Federal taxes and for Federal payments other than payments under the Internal Revenue Code of 1986 (Federal EFT Mandate).

Federal agencies primarily use the ACH Network to make recurring payments, such as salary payments. Federal agencies also use the ACH Network to make non-recurring payments, such as travel reimbursements and tax refunds, as well as payments to vendors and to grant and program recipients. The ACH Network is also used for non-tax collections, international funds settlement and for cash concentration from Treasury's more than 3,500 depositaries. FMS has already adopted a policy of accepting ACH credits to Treasury's General Account (TGA) in order to enable Federal agencies to collect payments such as fines, fees, and loan payments from the public by EFT.

In fiscal year 1997, FMS issued over 856 million payments, totaling in excess of $1.1 trillion, and collected over $1 trillion on behalf of Federal agencies, representing a variety of taxes, duties, fees, and fines. In fiscal year 1997, approximately 58% percent of Treasury payments were made through the ACH Network. In addition, a growing number of transactions involving the collection of funds by Federal agencies are being made through the ACH Network. In fiscal year 1997, FMS made 489 million payments through the ACH Network. In addition, in fiscal year 1997, FMS collected over $711 billion in taxes and more than $28 billion in non-tax collections using the ACH Network. As a result of the enactment of the DCIA and NAFTA, FMS expects to introduce up to 600 million additional transactions into the ACH Network by January 1, 1999. FMS anticipates that the ACH Network will provide the dominant, though not exclusive, EFT system used by Federal agencies. Part 210 will provide the regulatory foundation for use of the ACH Network by Federal agencies.

ALIGNING GOVERNMENT ACH RULES WITH THE PRIVATE SECTOR

As stated by FMS in the NPRM, "the use of private sector rules reduces the regulatory burden on financial institutions which otherwise might have to comply with conflicting or duplicative requirements." In recognition of this, FMS published an NPRM with respect to Part 210 on September 30, 1994. The purpose of the 1994 NPRM was "to provide a regulatory basis for the broader use of the ACH Network to meet the future payment, collection and information flow needs of the Government." FMS received fifty-one comments from Federal agencies, financial institutions, NACHA and its regional affiliates, and private sector organizations. All commenters expressed strong support of FMS's efforts to provide a regulatory basis for broader use of the ACH Network and to make the regulations more consistent with financial industry rules.

After considering the comments received on the 1994 NPRM, and taking into account developments since the 1994 NPRM was issued, in particular the enactment of the DCIA and NAFTA, FMS considered it necessary to issue this new NPRM.

The current NPRM contains two subparts. Subpart A sets forth rules applicable to all ACH credit and debit entries and entry data originated or received by a Federal agency. Subpart B contains the rules for the reclamation of benefit payments. Current Part 210 contains an additional subpart, subpart C, dealing with discretionary salary allotments. In addition, the 1994 NPRM proposed to add a new subpart D dealing with savings allotments. FMS has determined that subparts C and D are unnecessary because they are redundant to other rules.

Finally, several commenters indicated that the 1994 NPRM did not explain clearly the relationship between the NACHA Rules and Federal law or identify with sufficient clarity the specific NACHA Rules which FMS would preempt with respect to Government entries. This NPRM is intended to clarify that FMS adopts the NACHA Rules as the rules pertaining to Government entries, with certain exceptions as discussed below, for which FMS proposes to establish special rules as a matter of Federal law.

> **NACHA Response:** While the organization and wording of this proposed rule is significantly different from the 1994 NPRM, NACHA is pleased that FMS has largely adhered to its determination, expressed in the 1994 NPRM, that the NACHA Rules should also apply to ACH credit and debit entries and entry data originated or received by Federal agencies (defined in the proposed rule as "Government entries"). NACHA further understands that given certain exceptions, it may be necessary to reflect differences between the private sector and the Treasury, other Federal agencies, and the public interest. Our comments below address in each instance our view as to whether these exceptions, as proposed in this NPRM, are merited.

PROPOSED PREEMPTION OF NACHA RULES

Based on its review of the NACHA Rules, FMS considers that the special nature of Government entries, and the importance of protecting public funds, merits preemption, in whole or in part, several provisions of the NACHA Rules. These proposed preemptions, with NACHA's response, are described below.

Full Preemption

There are several provisions of the NACHA Rules that FMS proposes to preempt completely and these are specifically excluded from proposed 31 CFR Part 210's definition of "applicable ACH Rules" [see proposed Sec. 210.2(d)]:

ACH Members.

Proposed Part 210 would preempt the limitation on the applicability of the NACHA Rules to members of an ACH association.

The ACH Operating Rules developed and administered by NACHA allocate rights and liabilities

among participants to an ACH transaction.[2] Because the NACHA Rules employ terminology that is based upon the relationship between private financial institutions and their customers, the definitions used in the NACHA Rules do not address explicitly the roles of Federal agencies, FMS and the Federal Reserve Banks with respect to the origination or receipt of an ACH entry. From a functional perspective, the Federal agency that certifies an ACH entry to FMS performs a function that is analogous to that of the originator of the entry for purposes of the NACHA Rules. In disbursing the payment, FMS is acting as the ODFI and the Federal Reserve Bank is the originating ACH Operator with respect to the entry. Similarly, a Federal agency that receives a payment through the ACH Network, functions as the receiver, while FMS functions as the RDFI, and the Federal Reserve Bank functions as the receiving ACH Operator for the entry.

The NACHA Rules generally require ODFIs and RDFIs to assume responsibility for entries originated and received by their customers. ODFIs and RDFIs must make certain warranties with respect to entries originated and received by their customers and are liable to other participants in the ACH Network for breach of those warranties. The NACHA Rules do not impose direct liability upon originators and receivers; any losses resulting from an act or omission by an originator or receiver are imposed on the ODFI or RDFI. The ODFI or RDFI can seek recourse against the originator or receiver if it has the right to do so under the contract between the parties and/or applicable law.

NACHA Response: We recognize that in initiating and receiving Government entries, Federal agencies, Federal Reserve Banks and FMS operate in unique capacities that sometimes differ from the roles contemplated by the NACHA Rules. When present, these differences are a result of the statutory authorities that govern Federal Government payments and collections, and that distinguish Government entries from commercial or consumer entries involving private parties and financial institutions. Moreover, in the private sector, the effect of the NACHA Rules is typically extended to originators and receivers through originator/ODFI agreements and receiver/RDFI agreements, respectively. Consequently, for Government entries, it is entirely appropriate and certainly more efficient for FMS to impose uniformity on these relationships through the rule, as opposed to negotiating separate arrangements for each Federal agency, Federal program, or Federal payment recipient.

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[2] The NACHA Rules are structured upon the premise that five entities participate in the ACH Network. They are: (1) the originator, which is the person or entity that agrees to initiate ACH entries in accordance with an arrangement with a receiver; (2) the originating depository financial institution (ODFI), which is the institution that receives payment instructions from the originator and forwards the entries to an ACH Operator; (3) the ACH Operator, which is a central clearing facility, operated by a Federal Reserve Bank or a private organization, that receives entries from ODFIs, distributes the entries to appropriate receiving depository financial institutions and performs the settlement function for the affected financial institutions; (4) the receiving depository financial institution (RDFI), which is the institution that receives ACH entries from the ACH Operator and posts them to the accounts of its depositors; and (5) the receiver, which is a natural person or organization that has authorized an originator to initiate an ACH entry to the receiver's account with the RDFI.

Compensation and Arbitration.
Proposed Part 210 would preempt the compensation rules established through the NACHA Rules. Proposed Part 210 also would preempt the provision that disputes among participants may be settled through arbitration procedures set forth in the NACHA Rules. FMS' position is that it is inappropriate to assume liability arising from the acts and omissions of Federal agencies originating and receiving ACH entries. Accordingly, although it is FMS's view that Federal agencies operate as originators and receivers and FMS operates as an ODFI and RDFI from a functional perspective, FMS believes it is appropriate to impose upon Federal agencies that originate or receive ACH entries the obligations and liabilities imposed on ODFIs and RDFIs, respectively, for purposes of the NACHA Rules. Proposed Part 210 therefore is structured on the premise that Federal agencies are subject to all of the obligations and liabilities imposed on ODFIs and RDFIs under the NACHA Rules, except as otherwise provided in Part 210.

NACHA Response: While it may be appropriate for FMS to impose on Federal agencies originating or receiving ACH transactions those liabilities borne by ODFIs and RDFIs under the NACHA Rules, proposed section 210.6 (see below under "Partial Preemption") would effectively limit such liability to the amount of the transaction. Agencies would be exempt from liability for consequential damages, attorneys' fees, lost use of funds, etc. NACHA believes the compensation and arbitration rules in the NACHA Rules represent an equitable means for resolving claims between ACH Network participants, including Federal agencies.

Reclamation.
The proposed reclamation provisions of Subpart B would preempt all NACHA Rules related to the reclamation of entries and the liability of participants that otherwise would apply to benefit payments. FMS is preparing to develop an automated reclamation process and questions whether the protection afforded to financial institutions by the current limited liability provisions of Subpart B may be outweighed by the processing costs of handling reclamations.

NACHA Response: We believe it is important for FMS to consider the costs imposed on financial institutions through the reclamation process but we defer to the responses from financial institutions as to whether it is in their best interest -- given their own assessment of any reclamation processing cost savings they may expect to realize -- to accept greater liability. If this cost/benefit analysis is not borne out for financial institutions, NACHA could not support any provisions under 31 CFR Part 210 that would have the effect of increasing an account-holding financial institution's liability in this regard.

Furthermore, we are concerned that the proposed definition of "actual or constructive knowledge" in 31 CFR Part 210.2 suggests that financial institutions would have an obligation to check obituaries. The current Rule specifically indicates that there is no such obligation, but this language appears to be dropped in the NPRM. Similarly, the proposed treatment of "the amount in the account" in Subpart B appears to delete the current provision that a

financial institution has a reasonable period of time to act upon a notice of death. This would result in increased liability to financial institutions for reclamations.

Timing of Origination.
Proposed Part 210 would preempt the requirement set forth in the NACHA Rules that a credit entry be originated no more than two banking days before the settlement date of the entry.

NACHA Response: FMS needs to clarify its intent and understanding of the operational effects of its proposed preemption of the two banking day origination window specified for credit entries under the NACHA Rules. In doing so, FMS must consider that in the ACH Network various costs are incurred by the RDFI to warehouse ACH entries received (e.g., memory usage, reporting, etc.) from an ACH Operator. Thus, the longer the period between the receipt of a credit and the settlement date of the entry, the greater the cost to the RDFI to process Government entries. Furthermore, the longer the period between a credit entry's origination and settlement, the greater the exposure to risk to the RDFI. For example, if a DNE entry is received that pertains to a Government credit entry that has already been originated but not yet settled, the RDFI may not be able to process the DNE with sufficient time to prevent the funds from the credit entry from posting to the receiver's account. For these reasons, we believe it would be inappropriate for the Federal Government to extend the origination window specified in the NACHA Rules if the effect would be to shift significant costs and risk to RDFIs.

Partial Preemption
In addition to the foregoing provisions of the NACHA Rules which proposed Part 210 would entirely preempt through the definition of "applicable ACH Rules," several other provisions of the NACHA Rules would be preempted in part by operation of specific sections of proposed Part 210. Those provisions are:

Verification of Identity of Recipient [proposed Secs. 210.4(a), 210.8(c)(2)].
Under the NACHA Rules, a receiver must authorize an entry before the entry may be originated and the ODFI warrants that the authorization is valid. The ODFI thus bears the ultimate liability for any loss resulting from a forged authorization under the NACHA Rules. Proposed Part 210 would impose a different rule for Government entries. Specifically, under proposed Sec. 210.4(a), a financial institution that accepts an authorization from a recipient would have to verify the identity of the recipient. The financial institution would be liable to the Federal Government for all entries made in reliance on a forged authorization that the institution has accepted. Thus, proposed Part 210 would preempt the ODFI warranty and liability provisions of the NACHA Rules by allocating liability to the RDFI if it accepts a forged authorization.

NACHA Response: NACHA believes that FMS needs to clarify what it would consider a

"forged" authorization. Furthermore, we find it troubling that FMS appears to be proposing through the rule and its related commentary a departure from the principle -- upheld in the NACHA Rules and elsewhere in proposed 31 CFR Part 210 -- of establishing the standard of care as exercising "commercially reasonable business practices" in the authorization process or having "actual or constructive knowledge" of a fraud.

In our view, a financial institution that has no knowledge of fraudulent intent should not be held to the strict liability standard proposed if it accepts and processes an enrollment for a recipient of Government entries, obtains normal identifying information in the process from the recipient according to "commercially reasonable business practices," and the enrollment is accepted by a Federal agency for the purpose of originating payments to that recipient as a qualified beneficiary. Moreover, FMS needs to make clear that the financial institution processing the enrollment is not expected to verify whether the recipient is, in fact, entitled to receive the Federal Government payment(s) in question.

Authorization for Debit Entries to Federal Agencies [proposed Secs. 210.4(a)(2), 210.8(c)(1)]. Proposed Part 210 would preempt the NACHA Rules with respect to the form of authorization required to initiate debit entries to a Federal agency. The NACHA Rules require that every entry be authorized by the receiver, but only require that the authorization be in writing in the case of debit entries to a consumer account. Under proposed Sec. 210.4(a), no person or entity (including any financial institution) would be able to initiate or transmit a debit entry to a Federal agency unless the agency has expressly authorized in writing (or through a similarly authenticated authorization) the origination of the entry by that particular originator. An ODFI transmitting an entry in violation of this requirement would be liable for the amount of the transaction, plus interest, under proposed Sec. 210.8(c)(1).

NACHA Response: Under the NACHA Rules, the authorization sought by FMS is typically handled by agreement. Therefore, we believe it is appropriate for FMS to establish this requirement under the rule. However, FMS should also clarify: (1) that the authorization provision includes the ability to rely on a single authorization for recurring debit entries; and (2) that this provision is not intended to limit or restrict a financial institution's right to send to a Federal agency a reversal entry that otherwise complies with the rule for reversals.

Prenotifications [proposed Secs. 210.6(b), 210.8(a)].
FMS is proposing to preempt the NACHA Rules in two respects in connection with prenotifications. In order to reduce the potential for misdirected entries, proposed Sec. 210.8(a) would require a financial institution that receives a prenotification relating to Government entries to verify the account number "and at least one other identifying data element in the prenotification." This requirement would supersede the NACHA Rules which specifically permit financial institutions to rely on the account number alone in posting a payment to an account.

Second, the origination of a prenotification is optional for all entries under the NACHA Rules. Proposed Sec. 210.6(b) would preempt the NACHA Rules by requiring that a Federal agency originate a prenotification before initiating a debit entry to a recipient's account.

Prenotification is optional for all credit entries.

NACHA Response: NACHA strongly objects to the proposed requirement that a financial institution receiving prenotifications relating to Government entries validate anything more than the account number. This requirement would result in substantial costs to financial institutions as manual exception processing would almost certainly be required to comply, particularly since there are no automated means by which the RDFI can distinguish a Government prenotification entry from any other entry. Furthermore, the NACHA Rule FMS seeks to preempt (as well as the Uniform Commercial Code) recognizes that the account number of a beneficiary to a payment should be verified by the originator when the payment was first authorized. We strongly oppose this preemption of the NACHA Rules since we find no justification the Federal Government to shift to the private sector substantially greater processing costs by not adhering to the same common sense principle as private corporations and financial institutions in this regard.

Regarding FMS' proposal to require Federal agencies to originate prenotifications before initiating debit entries, we believe this is appropriate. However, NACHA seeks clarification from FMS as to whether the Federal Government will, under revised 31 CFR Part 210, abide by the timeframe under the NACHA Rules specified before the first dollar entry can follow its related prenotification entry.

Liability of the Federal Government -- Amount of Damages [proposed Sec. 210.6].
In general, the NACHA Rules impose liability on an RDFI or ODFI for all losses, liabilities or claims incurred by another depository financial institution (DFI), ACH Operator or Association as a result of the RDFI's or ODFI's breach of any warranty. Thus, under the NACHA Rules, a Federal agency that originates payments would be liable for all losses resulting from any breach by it of an applicable warranty under the NACHA Rules. Similarly, a Federal agency that receives payments would be liable for all losses resulting from any breach by it of an applicable warranty under the NACHA Rules.

Proposed Sec. 210.6 would limit a Federal agency's liability to the amount of the entry whether it is originating or receiving ACH entries. Therefore, a Federal agency would not be liable to a DFI, ACH Operator or an ACH association for interest, attorneys' fees, or other consequential damages. In addition, in certain circumstances, a Federal agency's liability may be further reduced by the amount of the loss judged to have been caused by a financial institution's negligence.

NACHA Response: As noted above, NACHA believes the compensation and arbitration

rules in the NACHA Rules represent an equitable means for resolving claims between ACH Network participants, including Federal agencies. We also believe the comparative negligence standard that would be imposed on financial institutions needs to be further explained as to how it would be administered by FMS or other Federal agencies and whether the cost of apportioning negligence would not exceed the benefit to the Federal Government of further limiting its liability in this fashion.

Liability of Federal Reserve Banks [proposed Sec. 210.7(a)].
Proposed Part 210 would preempt article 11.5 of the NACHA Rules, which provides that a Federal Reserve Bank is not the agent of an RDFI or ODFI. Proposed Part 210 would provide that Federal Reserve Banks are Fiscal Agents of the Treasury and would not be liable to any party other than the Treasury for their actions under Part 210.

NACHA Response: This proposed provision reflects the unique fiscal agent relationship between the Federal Reserve Banks and the Treasury Department that does not exist in the private sector and is therefore appropriate.

Liability of Financial Institutions [proposed Sec. 210.8(c)].
Proposed Part 210 would preempt the provisions of the NACHA Rules that would operate to make a financial institution liable to the Federal Government for any loss, liability or claim relating to an entry in an amount exceeding the entry. As previously indicated, the NACHA Rules impose liability on an RDFI or ODFI for all losses, liabilities or claims incurred by another DFI, ACH Operator or Association as a result of the RDFI's or ODFI's breach of any warranty. Under proposed Part 210, a financial institution would not be liable to the Federal Government for interest, attorneys' fees, or other consequential damages, except in the case of an unauthorized debit to a Federal agency, as discussed above.

NACHA Response: With the exception of the requirement to pay interest on an unauthorized debit to a Federal agency, this provision would establish parity with the liability borne by Federal agencies under the proposed rule. Consequently, NACHA supports the provision if the Federal Government limits its liability, as proposed, through the final rule. We reiterate, however, our view that the compensation provisions in the NACHA Rules represent an equitable means for resolving claims, including claims where a breach of warranty is attributable to either a financial institution or to a Federal agency.

Reversals [proposed Sec. 210.6(g)].
Proposed Part 210 would require Federal agencies initiating reversals to "certify" that the reversal does not violate applicable law or regulations. In addition, proposed Part 210 would apply to the Federal Government the NACHA Rules relating to indemnification, but limits the extent of the